

BPR on shares in loan companies

(Lecture B 1163 – 9.51 minutes)

BPR gives 100% relief from Inheritance Tax (IHT) on the value of shares in unlisted trading companies. Accessing BPR is therefore a crucial tool in IHT mitigation strategies for clients. Shifting non-qualifying assets and surplus cash into shares that are eligible for BPR can unlock massive IHT savings.

Before continuing, it is worth reminding you that the Pandora's Box marked BPR is only opened once the shares have been business property for two years, so this planning does not offer immediately rewards and a degree of forethought is required.

BPR is not available on shares in "investment" companies. More precisely and quoting legislation if I may, S.105(3) IHTA 1984 denies BPR where the business being operated is one which consists of "making or holding investments" or "dealing in land". The latter three words scupper the chances of BPR in property investment companies. Shares in such companies will suffer a full 40% IHT charge on death.

Quite what S.105 means by "making or holding investments" is less certain. As you can imagine, much hot air has been expended on this, but the 2006 case of *Executors of Rhoda Phillips v HMRC* [2006] does help clear the fog to a certain extent.

The Phillips case

Mrs Rhoda Phillips held shares in an eight separate property investment companies, all inherited from her husband, Philip Phillips, who had built up the businesses over a number of years until his death in 2000.

In 1989, one of the companies (PP Investments Ltd) sold its entire property portfolio and used the cash to extend loans to the other family property companies. On the death of Mrs Rhoda Phillips in 2001, the only assets of PP Investments Ltd were cash at the bank and amounts owed to it as largely unsecured debt (mainly from its related "sister" companies).

PP Investments Ltd had applied for and obtained a standard licence under the Consumer Credit Act and was therefore authorised to make loans to independent third parties (as well as its related companies). There were a handful of such loans.

PP Investments Ltd had amended its Director's Reports within its annual accounts and recorded its principal activity as being "property investment and providing finance". In reality its only activity was providing finance.

HMRC accepted that the company's activities had changed and reclassified it as a trading company for Corporation Tax (instead of a close investment-holding company which it had been before). [While this looks helpful 'on paper', the Courts will not necessarily be persuaded by this as Corporation Tax and IHT are entirely different animals.]

Mrs Phillips died in June 2001 triggering the question as to whether her shares in PP Investments Ltd qualified for BPR. The traditional dance took its natural course with HMRC denying BPR on the grounds that the company's business consisted "wholly or mainly of... making or holding investments", and the case finished up in the in-tray of the Special Commissioners. [Incidentally, the HMRC Capital Taxes Officer commented that he would have taken a different view if PP Investments Ltd had lent more widely in which case it could be analogous to a bank which is clearly a trading business.]

In reaching their decision, the Commissioners made a number of points.

- They were required to look at the activity of the business in the two years before Mrs Phillips' death and not the activity undertaken by the business in the past. The fact that the company had been a property investment business until 1989 was not relevant;
- They could not take a "blanket" approach and categorise lending as either "investment" or "non-investment" as the treatment depended on the nature of the lending activity. For example, the activity of money-lending is not normally regarded as an investment whereas other forms of lending (for example, holding debentures or investment bonds) would be more likely to be. They therefore needed to distinguish between "making loans" (which banks did) and "investing in loans" (which investors did);
- The fact that the loans were mainly used by the borrowers to make investments did not necessarily make the loans themselves investments. It was not relevant to the activities of PP Investments Ltd what the borrowers used the funds for. PP Investments Ltd was not entitled to any profit generated from the investments made by its sister companies (thereby bolstering the argument that the loans were not investments themselves).

The Commissioners decided that, on balance, PP Investments Ltd was in the business of making loans and not in the business of investing in loans. The loans were not investments for their own sake but were instead the provision of a finance facility to the other companies. Consequently the business of PP Investments Ltd did not consist wholly or mainly of making or holding investments, and 100% BPR was available in relation to the shares.

The Green Light?

HMRC did not appeal the Phillips decision and have thus far not taken any steps to counter this position.

The door therefore remains open for BPR planning along the following lines:

- Where a family company is carrying on an investment business (for example, property dealing), a money-lending business could be held alongside to provide finance. The shares in the money-lending company will qualify for BPR after two years. The associated debt in the property dealing company would reduce the value of its shares for IHT;

- Trading companies with surplus cash could establish an in-house money-lending subsidiary to provide cash to either other family companies or individual family members. In essence this is creating a “banking-arm” for in-house transactions. This would prevent significant cash balances within the trading company from becoming “excepted assets” (thereby avoiding any dilution of IHT within the structure);
- Family members with surplus cash (or non-BPR qualifying investments which could be turned into cash) could establish a new company or partnership to make commercial loans to family businesses or family members.

When set up correctly, the value of the loan-making company will be covered by BPR after 2 years and will not be chargeable to IHT on death.

Attending to the detail...

As with all successful planning, I's and T's must be dotted and crossed.

The company's Articles must be altered so as to allow it to operate as a money-lending business.

It is crucial that the business qualifies as a trade of making loans, rather than investing in loans. The good old “badges of trade” tests must therefore be applied.

According to our friends at HMRC: “Lending money at interest is normally an investment and any interest received is taxable as savings income. Whether the making of loans amounts to trade is essentially a question of fact and there has to be sufficient evidence of trading to displace the investment presumption”. [BIM62201]

Money-lending is only usually regarded as a trade in cases where it is an integral part of the business operations to employ capital to produce such income.

So boxes need to be systematically ticked here such as:

1. A high degree of organisation – for example, making advances, collecting repayments, pursuing late payers and producing related documents in a similar way to a bank or finance house. Ideally this means that the terms of any in-house loans should be similar to loans made on commercial terms between third parties. For example, a commercial rate of interest, bearing in mind any specific circumstances, should be charged and paid by the creditor company. Security is always good to have but (on the back of Phillips), the fact that some loans may be unsecured should not jeopardise the BPR position.
2. The number of lending transactions is significant to help ensure that profits on performing loans can cover losses on non-performing loans. I'm not saying that a practitioner cannot win an argument that Company A, which exists solely for the purpose of providing finance on commercial terms to its sister Company B, is not in business as a money-lender. But it certainly strengthens one's hand if Company A has a few other clients.

3. Whether an application for authorisation under the Consumer Credit Act 1974 has been made to the Financial Conduct Authority (FCA). You must check if the proposed business requires FCA authorisation to carry out regulated consumer credit activities. I am not a financial adviser (and this should not therefore be seen in any way as financial advice). However it is my understanding (from the oracle that is Gov.uk) that business-to-business lending does not require FCA authorisation unless your customer is either:

- An individual (e.g., sole trader);
- A partnership with fewer than 4 partners; or
- An unincorporated association.

Either way, this will need to be researched and any relevant paperwork put in order before lending commences. A trawl through www.fca.org.uk is time well-spent.

Once the badges of trade boxes are ticked, the money-lending business should report its income on its tax return as trading income rather than as loan relationship non-trade credits. The company's accounts should also record its trading status.

As mentioned above, the fact that the Corp Tax arm of HMRC accepts that we have a money-lending trade cannot always be regarded as 100% persuasive to those in the Capital Taxes Office who are looking at this through their IHT-tinted glasses. But it certainly helps and one is automatically on the back foot if the trading wrapper isn't there.

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